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REVIEW OF BARRY R. LITMAN, THE VERTICAL STRUCTURE OF THE TELEVISION BROADCASTING INDUSTRY: THE COALESCENCE OF POWER

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Litman, Barry R., <u>The Vertical Structure of the Television Broadcasting Industry: The Coalescence of Power</u>, East Lansing, Michigan: Michigan State University (1979).*

Barry Litman's book fits comfortably within the Federal Communications Commission's traditional view that the dominance of the television industry by the three major networks can be reduced by regulating their commercial practices. Although Litman recognizes that FCC spectrum allocation policies for broadcasting and policies affecting television systems that use alternative technologies have been responsible for the high degree of concentration in network television, he nevertheless remains sanguine about the prospects for improving industry performance by placing limits on contractual arrangements between the networks and other industry participants. Thus, as he examines the dealings of the networks with affiliated stations, with program producers, and with advertisers, he is continually searching for new rules that might lessen the role played by the three dominant networks and facilitate the growth of new program sources within the existing broadcast system. Throughout, Litman's concern is to establish that the power of ABC, CBS, and NBC stems from the manner in which they deal with their local distributors, their suppliers, and their customers and to find ways to reduce that power by regulating their practices.

In 1980, the FCC Network Inquiry Special Staff (of which I was Co-Director between 1978 and 1980) presented to the Commission its own analysis of network dominance.[1] Like Litman, the Network Inquiry concluded that the source of the problem of network dominance could be found in Commission policies that had erected barriers to the formation

*This review is forthcoming in <u>The Antitrust Bulletin</u>.

of additional networks. Unlike Litman, however, it argued that little or nothing in the way of improved industry performance could be expected from extending traditional regulation of network behavior and that the result of doing so would be to force the industry increasingly to adopt inefficient commercial practices. Instead of urging the extension of regulation, therefore, it recommended that most existing rules be repealed. It concluded that only by removing barriers to the creation of new networks could the Commission enhance the ability of the industry to serve the viewing public. In this review, I draw upon the Final Report of the Network Inquiry Special Staff and its associated background reports and attempt to show why the Inquiry reached conclusions so at variance to Litman's and why the adoption of policy recommendations such as his are likely to do more harm than good.

The Network Inquiry--the third major examination by the FCC of the question of network "dominance"--began in 1977 with a mandate to examine a wide array of network commercial practices involving dealings between the networks and their affiliates, on the one hand, and their program suppliers, on the other. In particular, the Commission asked whether existing practices limited the access of non-network program suppliers to the time of affiliated stations, whether these practices were in the public interest, and how existing regulations might be improved.

Historically, the Commission has attempted to deal with network dominance within a system in which at most three nationwide outlets for programs could operate simultaneously. Since 35 percent of all households do not receive four commercial signals and many viewers receive their fourth service over the inferior UHF band, the prospects for a fourth over-the-air advertiser-supported television network are severely limited. Rather than attempt to expand the number of networks that can operate simultaneously, either by radically revising its spectrum allocation plan, or by dismantling barriers to the growth of cable and pay television, however, the Commission has chosen to regulate network practices in an attempt to increase the number of competing entities within a system having a limited number of outlets.

Thus, the Commission has established rules to prevent exclusive affiliations, has prevented networks from acquiring options on the time of their affiliates, and has placed constraints on the form of compensation paid to affiliates, all in an attempt to prevent the three major networks from acquiring a monopoly of their affiliates' time.

More recently, the Commission has established rules designed to enhance the bargaining power, and hence the financial well-being, of the independent suppliers who produce the bulk of network entertainment programs. These rules prevent the networks from acquiring profit shares in independently-produced programs, or from becoming agents for independent suppliers in the syndication market, where programs are sold on a station-by-station basis.

The rules preventing the networks from acquiring profit shares and syndication rights--the financial interest and syndication rules--were accompanied by a rule that prevents the three major networks from supplying more than three hours of programming during the highly-profitable prime time hours to their affiliates in the top 50 markets. The Prime Time Access Rule, the culmination of 25 years of FCC regulation of the television networks, was simultaneously to free affiliates from having to choose network programs and to open a market to independent suppliers.

This panoply of regulations proceeds from the premises that the networks are the adversaries of their affiliates and suppliers, that the networks have an unfair advantage in these relationships, and, most important, that a redressing of the imbalances will benefit not only affiliates and suppliers but the viewing public as well. However, each round of regulation has ended in frustration as the promised benefits failed to materialize, and suggestions for still more regulation have resulted. The Network Inquiry Special Staff concluded, on the basis of this experience, that only increases in the number of television outlets and direct viewer payments could improve viewer welfare. The Inquiry argued, further, that banning a limited number of commercial practices was unlikely to reduce whatever market power the networks may possess, since alternative means are often available for the exercise of that power. Finally, it held that regulation had led to the adoption of inefficient practices, to higher costs, and to poorer industry performance.

Litman seems, at times, to agree with much of this analysis, characterizing policies such as the ban on option time and the Prime Time Access Rule as failures. However, he attributes this to the fact "that marginal structural solutions will not bring about the desired results" and that "a radical restructuring of (the affiliation) contracts as a means of inducing greater competition among stations, encouraging entry of new programming, and increasing the quality of such programming" (pp. 48-49) is needed.[2] His "radical restructuring" consists essentially of preventing networks from offering an extensive lineup of programs to a large number of stations on a regular basis. Instead, each program would have to be offered station-by-station with sales to the highest bidder. It is, however, difficult to see how this policy recommendation is consistent with the author's conclusion that the Prime Time Access Rule (PTAR) has "failed" (p. 48), since the proposal amounts to little more than PTAR "writ large." Indeed, the only difference is that ABC, CBS, and NBC, the only program sources currently affected by the Rule, would be able to supply programs, although not through ongoing affiliation relationships. It is not clear how Litman expects viewers to be made better off since his proposal, like PTAR, would increase costs--by requiring the adoption of an inefficient distribution system--while leaving the number of broadcast outlets unchanged.

Litman does argue that one benefit from his proposal will be to enhance the ability of existing independents to acquire "network" programs. But even assuming, unrealistically, that the policy leaves programming unaffected and that independents frequently do outbid affiliates, the benefits to viewers from having a program available on one channel rather than another seem non-existent. More realistically, viewers are likely to be made worse off, since the adoption of a more costly distribution system is likely to affect programming adversely.

The principal benefit that Litman seems to envision from breaking up the network-affiliate relationship is that the profitability of independent stations will increase.[3] The theme that the redistribution of industry profits away from the networks is a valid policy objective appears elsewhere in Litman's book and has been an important element of FCC policy for many years. But it is arguable whether the distribution of industry profits should be of concern to the Commission unless it affects the well-being of viewers. In this case, the result of redistributing profits is almost certainly to make viewers worse off, since distribution costs are increased when station-by-station program sales replace the network-affiliate relationship. The experience under the Prime Time Access Rule provides ample evidence on this point.

A similar concern with enhancing the profitability of independent program suppliers causes Litman to be critical of increased "in house" program production by the networks and of network acquisition of profit shares and syndication rights in independently produced programs. Litman accepts, with little reservation, the claims of program suppliers and the Department of Justice that the acquisition of these rights and the failure of network license fees to cover supplier production costs has rendered program supply unprofitable. Why suppliers continue to produce in the face of what appear to be consistent losses is a puzzle to Litman.[4] One reason he provides is that these losses are simply the price that producers pay for the pleasure of "being part of the 'Hollywood scene'" (p. 92),which should come as something of a shock to the shareholders of Gulf and Western (parent of Paramount), MCA (parent of Universal), and Transamerica (parent of United Artists). It is only with the greatest reluctance that Litman admits the possibility that the prospects of large returns in "off-network" syndication may bring forth supply even in the face of network license fees below production costs.

Litman's analysis of program supply reveals most sharply two of the principal shortcomings of his entire book. First, without independent verification, he accepts almost any "fact" that seems critical of the actions of the networks. Thus, for example, he repeats the claim made by the Department of Justice that the license fee that will be paid in each year is determined at the beginning of the five-year option period common to most network entertainment program contracts. His "evidence" consists of DOJ exhibits detailing the terms of the initial contracts for two program series. But it is generally known in the industry that license fees are routinely renegotiated for subsequent years if a program is renewed after its first season.[5] Unsurprisingly, the creative inputs of a successful series may acquire market power after the program appears on the network and in the resulting bilateral monopoly are usually able to negotiate higher fees.

Second, Litman fails to appreciate how difficult it is to transfer profits from the networks to suppliers. The effect of a ban on the acquisition of syndication rights or profit shares, for example, can be offset by changes in other contract provisions, including a reduction in the network license fee.[6] Moreover, he fails to make clear how, even if profits could somehow be shifted, viewers would benefit. If Twentieth Century Fox makes larger profits from "MASH," is it really plausible that it will, as a result, choose to produce unprofitable programs?

Litman cites evidence that "television tends to program according to the mass-appeal choices of the public and emphasizes uniformity rather than diversity" (p. 36), but fails to note that this results from the relatively small number of outlets and not from the existence of networks. Indeed, the evidence on program uniformity he reports comes from the Prime Time Access period, when the networks do not provide programs! And although he recognizes the efficiencies that the networks produce--"their ability to reduce costs to broadcasters (by simultaneous broadcasting), to national advertisers (by diminishing the number of transactions required), and to program suppliers (by central dealing and long-term commitments)"--he objects to network "production of programs, ownership of stations, and various other related activities subsidiary to their major role in television" (p. 24).

Little would be lost (or gained) if networks could not own stations or produce programs. Most of their local distributors are presently independently owned and, except for news and public affairs, most of their programs are produced by others. But much would be lost if Litman's proposal were adopted and syndication replaced the network-affiliate relationship everywhere. And viewers would lose, as well, if the networks could not participate in the development of programs.

Litman insists on believing that no efficiencies result from ongoing network-affiliate relationships or from network involvement in program acquisition, and that they are engaged in by the networks solely to foreclose the entry of other program sources. These functions, which could easily be rationalized as leading to lower costs are, inevitably, seen by Litman as motivated solely by desire by the networks to control their environment and to increase their power over others. To be sure, the networks do wish to foreclose entry, but doing so is not without its costs and there are, thus, limits on the extent to which predatory behavior will be pursued.[7]

At the same time, it is exceedingly difficult for the FCC to distinguish practices that promote efficiency from those that are designed to thwart competitors, with the result that it is difficult for the Commission to invoke remedies that do more good than harm. Most important, however, only structural changes--increasing the number of outlets and providing for direct viewer payments--are likely to improve the fare available to viewers. As a result, the Network Inquiry Special Staff recommended that the FCC remove the last vestiges of regulatory-created barriers to entry, requiring ABC, CBS, and NBC to compete more vigorously with other networks for advertising, for programming, and, especially, for viewing.

FOOTNOTES

[1]Federal Communications Commission, Network Inquiry Special Staff, New Television Networks: Entry, Jurisdiction, Ownership and Regulation, 1980.

[2]All page references are to Litman.

[3]One of the effects of PTAR has apparently been to increase the profits of independents, in part by permitting them to carry "off-network" reruns during the access period while restricting affiliates to the carriage of original syndicated programming. However, in citing evidence on the ability of independents to compete for audience during the access period period, Litman fails to note this restriction on affiliates' programming choices, contending that competition for programming during the access period is "on an equal footing" (p. 53).

[4]Litman cites as evidence the claim of the head of a "highly successful" production company, now the President of NBC, that the company "loses money on all its shows" (p. 92).

[5]This has subsequently been confirmed by an extensive series of interviews with program suppliers and by a detailed examination of the contract files for a large number of network series (see Federal Communications Commission, Network Inquiry Special Staff, An Analysis of Television Program Production, Acquisition and Distribution, 1980), but it could have been discovered by Litman, as well.

[6]One obvious question is why suppliers continue to ask for ineffective relief. One possible answer is that rules limiting the rights the networks can acquire differentially disadvantage new or small suppliers who have poorer access to alternative sources of financing than do the major motion picture studios.

[7]Curiously, although Litman suggests in many places that the networks are vertically integrated in order to deter entry, he argues that the likelihood that integration into program production will be used to foreclose "seems very remote" (p. 13), and that "there is no concrete evidence on squeezes" resulting from station ownership (p. 14).

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